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Research paper



Rethinking Debt in Defense Firms: Why Profitability Beats Liquidity In Bandung, 2017–2024

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Abstract

This study aims to analyze the effects of profitability and liquidity on capital structure in the defense industry in Bandung during the period 2017-2024. Using a descriptive-verification quantitative approach, this study uses secondary data derived from the company's financial statements. Profitability is proxied by the net profit margin (NPM), liquidity by the current ratio (CR), and capital structure by the debt-to-equity ratio (DER). The results show that neither profitability nor liquidity significantly affects capital structure, either partially or simultaneously. However, NPM shows potential as a reliable indicator to manage capital structure in accordance with industry standards. These results suggest that increasing internal profitability can be a key strategy for the defense industry in Bandung in strengthening the sustainability of its capital structure.

Keywords: *Capital Structure; Current Ratio; Debt-to-equity Ratio; Liquidity; Profitability.*

1. Introduction

In today's dynamic and increasingly complex economic landscape [1]Indonesian firms—ranging from micro, small-, and medium-sized enterprises (MSMEs) to large-scale manufacturers—are intensifying their efforts to improve operational quality, efficiency, and scale as part of a broader push toward national economic resilience and global competitiveness [2], [3]. This intensification, often pursued through technological upgrading, export expansion, and supply chain integration, places mounting pressure on firms to secure adequate funding. Access to sustainable and strategic financing has thus become a central issue for both private and state-owned enterprises (SOEs) in Indonesia [4], [5], [6], [7].

Amid these challenges, corporate capital structure decisions—how firms choose between internal resources (e.g., retained earnings) and external financing (e.g., debt or equity)—have emerged as vital determinants of business performance and long-term value creation [2], [8], [9]. In Indonesia, the financing behavior of firms often follows a pecking-order theory logic: companies typically prioritize internal funding when it is profitable, turn to debt financing as a second option, and only issue equity as a last resort owing to its dilutive nature and signaling risks [10], [11]. However, this theoretical preference can diverge in practice due to institutional, sectoral, or macroeconomic constraints.

Building on institutional theory [12]State-owned enterprises often conform to regulatory and political pressures that drive financial decisions beyond efficiency or market rationality. Coercive isomorphism manifests through government mandates—such as procurement rules or budget allocations—that dictate financing strategies irrespective of profitability or liquidity. Normative pressures from professional networks and managerial norms within SOEs further reinforce reliance on state-backed debt instruments and equity injections [13]. At the same time, mimetic behaviors emerge when firms imitate financing structures of peer SOEs under uncertainty, leading to patterned but suboptimal leverage practices [14]. This institutional lens helps explain why Bandung's defense firms deviate from conventional capital structure theories, as their financial behavior reflects compliance with state expectations rather than optimization of shareholder value.

For example, research on Indonesian listed manufacturing firms has shown a paradox in investor behavior: market participants often interpret a firm's reliance on internal financing as a sign of excessive conservatism or missed expansion opportunities, whereas moderate external debt issuance tends to be viewed positively—as a signal of growth intent and capital efficiency [15]. This pattern underscores the nuanced implications of capital structure choices, especially in sectors with strategic importance and unique governance frameworks, such as defense manufacturing.

The post-pandemic era has further heightened the urgency of optimal capital structuring. Despite global deleveraging trends following the COVID-19 shock, Indonesian financial institutions—including banks and multifinance firms—have shown strong lending activity to support industrial revitalization [16]. For capital-intensive industries, particularly those aligned with national development priorities, access

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to external financing remains essential to scale up production, invest in innovation, and achieve strategic objectives. However, the strategic deployment of capital—balancing profitability, risk, and stakeholder expectations—has become more complex than ever.

Operational expansion in capital-intensive firms significantly increases the demand for working capital and long-term investment financing [17]. Firms must navigate the dual challenge of funding daily operations while committing capital to transformative growth initiatives [18]. When internal funds are insufficient, external debt and equity financing become critical. Debt, while offering tax advantages and no ownership dilution, imposes fixed obligations that can strain liquidity and increase default risk. Conversely, equity financing avoids mandatory repayments but may dilute ownership and signal distress if overused. Ortiz-de-Mandojana and Bansal [19] argue that financial decisions are strategic levers that determine not only short-term survival but also long-term sustainability. Similarly, Keay [20] emphasized that capital structure optimization is a balance of risk and reward that enhances shareholder value.

In this context, capital structure serves as a proxy for a firm's financial health and strategic posture. Scholars highlight that an optimal capital mix is neither static nor universal but must be tailored to industry dynamics, asset structures, and firm-specific characteristics [21], [22]. Thus, understanding the interplay between profitability, liquidity, and leverage becomes crucial—especially for firms under dual mandates, such as state-owned defense manufacturers.

The defense manufacturing sector in Bandung, West Java, exemplifies the complex interplay of commercial viability and national strategic alignment [23]. These SOEs are not only tasked with producing defense equipment but also with fulfilling broader national security objectives, often under tight fiscal oversight and policy mandates [24], [25], [26]. Their financial performance is shaped by internal operational factors—such as production efficiency, asset turnover, and cost management—and external regulatory influences, including procurement policies, subsidies, and refinancing directives [27], [28].

In such firms, the debt-to-equity ratio (DER) is a critical indicator, reflecting the relative weight of external borrowing versus internally generated equity. High DER values may signal aggressive leveraging, which, while facilitating rapid asset accumulation or project financing, also increases interest burden and insolvency risk if not managed prudently. In Bandung's defense industry, DER trends from 2017--2024 reveal a pattern of persistently high leverage: the ratio peaked at 391.6% in 2017, dipped to 201.37% in 2022, and rose again to 342.99% in 2024—consistently breaching the firm's internal 300% ceiling. These figures strongly contrast with general Indonesian industrial norms, where DER values above 90% are considered risky, and anything exceeding 300% denotes extreme financial exposure [29].

This pattern of volatile leverage suggests inconsistent capital management practices, which likely undermine financial performance and strategic agility. Elevated DER not only reduces operational flexibility but also dampens investor confidence and inflates financing costs [30]. Empirical studies on Indonesian SOEs in the defense sector have demonstrated that excessive leverage tends to erode profitability, particularly return on equity (ROE), as high interest obligations consume earnings [31], [32]. Thus, the capital structure of Bandung's defense firms is not merely a reflection of financing preferences but also an indicator of systemic fragility and the need for reform in financial governance.

To assess the financial dynamics of such firms, analysts typically rely on quantitative financial ratios extracted from audited financial reports [33]. Among these, the net profit margin (NPM) serves as a measure of profitability, indicating the proportion of revenue converted into profit. A high NPM signals efficient cost control and revenue realization [34], [35], [36]. In contrast, the current ratio (CR) measures short-term liquidity, reflecting a firm's ability to meet immediate obligations [37]. A CR below 1.0 generally signals solvency concerns, whereas excessively high CR values may suggest underutilized assets [38]. Both indicators—when evaluated alongside DER—can reveal structural imbalances and financing stress points.

Prior research confirms the relevance of these indicators for capital structure decisions [39], [40], [41]. Studies by Rajan & Zingales [42], Booth et al. [43], and more recently, Hermuningsih [44], find that both profitability and liquidity significantly influence leverage levels—although their relative effects vary by industry, firm size, and governance structure. In the case of Bandung's defense sector, historical financial data reveal erratic trends in NPM and CR. This irregularity suggests a misalignment between internal performance and external financing behavior, pointing to the need for more deliberate and policy-informed financial strategies [45].

This study investigates how profitability (NPM) and liquidity (CR) affect capital structure (DER) in Bandung's defense manufacturing industry from 2017--2024. It aims to answer the following research questions:

1. What are the trends and conditions of profitability, liquidity, and capital structure in the defense manufacturing sector during this period?
2. Does profitability (NPM) significantly influence capital structure (DER) individually?
3. Does liquidity (CR) have a significant individual effect on capital structure (DER)?
4. Do both profitability and liquidity simultaneously affect capital structure?

By analyzing empirical data over these seven years, this study contributes to the discourse on capital structure determinants and offers insights for SOE financial policy in Indonesia. It addresses the challenges of managing leverage under state ownership, public-sector governance constraints, and the need for evidence-based financial reform to strengthen industrial resilience in emerging economies.

2. Methods

The research method employed in this study integrates descriptive-verificative quantitative analysis to examine the influence of profitability and liquidity on capital structure within a defense industry context. This methodological approach holds notable utility and novelty, particularly in its application to a strategic sector such as the defense industry—an area often underexplored owing to data confidentiality and limited accessibility. By targeting a state-owned defense manufacturing company in Bandung from 2017–2024, this research captures an extended post-reform industrial landscape, marked by both macroeconomic and sectoral shifts.

The quantitative approach was selected for its ability to provide empirical generalization and objective hypothesis testing through numeric data analysis [46], [47], [48], [49]. In this context, the descriptive method is used to illustrate the trends and dynamics of key financial indicators—the net profit margin (NPM), current ratio (CR), and debt-to-equity ratio (DER)—offering a foundational understanding of a company's financial structure over time. The verificative aspect, on the other hand, applies inferential statistics to test theoretical relationships, thereby enabling a data-driven examination of how internal financial performance metrics influence capital structure decisions.

However, it is important to acknowledge certain methodological limitations. First, the empirical model is restricted to firm-level financial indicators, which narrows the explanatory scope. Broader macroeconomic variables—such as interest rates, inflation, and exchange rate fluctuations—as well as non-financial factors like political cycles, procurement timing, and state budgetary decisions, were not empirically tested. Second, the study focuses on a single state-owned enterprise, which limits the generalizability of the findings. The small sample size (n=8 years of observation) further constrains statistical power, increasing the possibility that relationships observed may not hold

across other firms or time periods. These limitations highlight the need for future research that incorporates panel data, cross-firm comparisons, and additional variables to capture the complexity of capital structure decisions in state-owned strategic industries.
2.1 Participants The unit of analysis is unique: a single state-owned enterprise in the Indonesian defense sector. Unlike typical financial performance studies in commercial firms, this focus enhances the research's novelty by providing insights into public industrial policy, financial risk management, and governance mechanisms within a strategic and often opaque sector [50]. Utilizing audited annual financial reports from 2017–2024 ensures the reliability and validity of secondary data, minimizing bias and aligning with best practices in archival financial analysis [51]. These reports were obtained from the Accounting and Finance Division and include income statements and balance sheets. Given the archival nature of the study, no human subjects were involved.

2.2 Data collection

The data used in this study are secondary in nature and derived from the defense industry in Bandung's official financial statements. Data were collected through two primary techniques: library research and field documentation. Library research involves the study of relevant literature, including books, journals, and previous theses, to construct a theoretical framework. Field documentation was conducted by collecting the company's financial data—specifically, the net profit margin (NPM), current ratio (CR), and debt-to-equity ratio (DER)—from internal financial documents.

2.3 Data analysis

The data analysis framework includes both descriptive statistics and multiple linear regression analysis, a robust econometric technique suitable for testing causal relationships in cross-sectional time series data [52]. The regression model identifies the effects of NPM and CR on DER, facilitating precise estimation of partial and simultaneous influences through t-tests (partial influence) and F tests (simultaneous influence), respectively. The significance level is set at $\alpha = 0.05$, a standard threshold for inferential robustness. The regression model used is as follows:

$$Y = a + b_1X_1 + b_2X_2 + \varepsilon$$

where:
Y = Capital structure (proxied by DER)
X_1 = Profitability (proxied by NPM)
X_2 = Liquidity (proxied by CR)
a = constant
b_1, b_2 = regression coefficientsε = error term

Moreover, the study employs Pearson correlation coefficients to measure the strength and direction of relationships among variables and the coefficient of determination (R^2) to evaluate the model's explanatory power. These tools provide deeper insights into financial decision-making dynamics, especially in a state enterprise context where policy and fiscal responsibility are often intertwined.
All computations are conducted via SPSS version 20, ensuring standardized statistical procedures and reproducibility. The combined methodological elements—longitudinal design, integration of descriptive and verificative logic, and application to a strategic state sector—constitute the novelty and utility of this study.

3. Results

This research was conducted in the defense industry in Bandung from 2017--2024 on the basis of annual financial report data. The data processing carried out in this study was assisted by SPSS version 20 and Microsoft Excel tools.

3.1 Descriptive analysis

3.1.1 Introduction: framing the strategic relevance of financial analysis in the defense sector

Profitability is a ratio used to determine a company's ability to earn profits or profits. Profitability in this study is proxied by the net profit margin/NPM, which is a ratio that shows a company's net income by comparing net profit after tax with sales. According to the results of the study, a description of profitability proxied by the net profit margin/NPM at the defense industry in Bandung for the period 2017--2024 is as follows:

Table 1: Profitability of the defense industry in the Bandung period from 2017--2024

Years	Net Profit (IDR)	Sales (IDR)	Profitability
2017	34.221.244.016	1.105.833.652.502	3,09
2018	47.199.890.431	1.265.861.930.306	3,72
2019	76.912.577.826	1.508.057.526.254	5,10
2020	97.603.963.388	1.877.573.542.747	5,19
2021	52.415.667.058	1.480.280.339.732	3,54
2022	4.160.941.076	1.948.821.017.890	0,21
2023	45.791.536.023	2.025.443.999.847	2,26
2024	92.062.437.600	2.470.172.079.414	3,72

Source: Financial Statements Process

As shown in Table 1, the profitability of the Bandung-based defense industry, as measured by the net profit margin (NPM), fluctuated significantly from 2017--2024 because of changes in government procurement cycles and external economic conditions. From 2017 to 2020, the NPM rose from 3.09% to 5.19%, driven by improved production efficiency, rising sales (up to IDR 1.878 trillion), and better alignment between contract fulfillment and revenue realization. However, from 2021--2022, NPM fell sharply to 0.21% due to reduced

Ministry of Defense allocations, election-related contract delays, and exchange rate losses from import dependency. A recovery occurred from 2023–2024, with NPM restored to 3.72% as sales increased (IDR 2.025 trillion in 2023 and IDR 2.47 trillion in 2024) through aggressive marketing and the successful acquisition of government contracts from TNI, the Ministry of Defense, and POLRI. The company's reliance on centralized defense and security institutions—nearly 80%—makes its financial performance sensitive to national procurement policies. While it has diversified modestly to serve the Ministry of Forestry, Customs, and select BUMNs such as PT KAI and PT PLN, this diversification is insufficient to buffer against major public sector fluctuations, highlighting the need for a more balanced client portfolio to sustain long-term profitability.

The average value of profitability in the defense industry in Bandung is 3.3538 or 3.35%, meaning that the company has a high dependence on additional capital from outside (external) parties because the low level of profit allows the company to use external sources of funds, such as debt [53]. A company's sales are strongly influenced by the procurement policies of its main customers, making the conditions unfavorable. In practice, profitability is still below the industry average because a good industry standard is 20% [54].

The defense industry in emerging economies such as Indonesia plays a pivotal role not only in national security but also in industrial capability building and technology transfer [55], [56]. The Bandung-based defense industry, which serves primarily institutional buyers such as the TNI, Ministry of Defense, and POLRI, represents a strategic node of this ecosystem. However, it operates within a financially volatile landscape because of its high dependence on state procurement cycles, external shocks (e.g., elections, currency fluctuations), and limited private-sector diversification.

This volatility can also be understood through the lens of institutional theory [12], which explains how organizations—particularly state-owned enterprises—conform to institutional pressures rather than purely market rationality. In this case, coercive isomorphism arises from government procurement regulations and budget cycles that dictate profitability outcomes regardless of internal efficiency. Mimetic pressures are reflected in the firm's reliance on debt financing strategies similar to other SOEs facing fiscal constraints, while normative pressures stem from professionalized accounting and reporting practices that reinforce compliance with state expectations. Thus, profitability fluctuations in Bandung's defense industry are not merely a result of operational factors but also of institutional conformity to political and regulatory mandates. This perspective clarifies why profitability remains persistently below industry benchmarks, despite periodic efficiency gains, and why capital structure strategies are more reflective of institutional survival than of optimal financial performance.

This research contributes to the literature on corporate financial performance by applying financial ratio analysis and regression modeling to analyze the determinants of capital structure. Unlike most financial studies that focus on commercial industries, this study isolates profitability and liquidity as internal determinants within a quasipublic, defense-oriented industry over eight years. The novelty lies in the sectoral context, the data granularity, and the combination of descriptive and inferential modeling approaches, which are often rare in public-sector financial studies [57], [58].

3.1.2 Fluctuating profitability and external procuring cycles

Liquidity is the ability of a company to meet short-term obligations or debts that must be paid immediately by comparing total current assets with total current liabilities (short-term debt). The liquidity (X_2 In this study is proxied by the current ratio (CR). The current ratio or current ratio) It is a ratio used to measure a company's ability to pay short-term liabilities or debts that are due immediately when billed as a whole. According to the results of the present study, a description of liquidity proxied by the CR at the defense industry in Bandung for the period 2017--2024 is as follows:

Table 2: Liquidity of the defense industry in the Bandung period from 2017--2024

Years	Current Assets (IDR)	Current Debt (IDR)	Liquidity (%)
2017	1.068.533.991.298	695.661.336.168	153,59
2018	1.012.938.492.488	818.730.133.076	123,72
2019	2.118.401.148.340	1.547.609.071.913	136,88
2020	2.661.976.078.511	1.867.640.265.487	142,53
2021	2.374.561.797.989	1.763.997.675.538	134,61
2022	3.497.747.173.886	2.286.104.541.739	153
2023	3.579.705.296.586	2.342.295.627.561	152,82
2024	5.401.111.140.156	3.079.864.157.683	175,36

Source: Financial data and records of the defense industry in Bandung

According to Table 2, between 2017 and 2024, the liquidity position of the Bandung defense industry, as reflected in its current ratio (CR), fluctuated due to changes in assets and liabilities influenced by state procurement cycles, inventory strategies, and vendor transactions. The CR ranged from a low value of 123.72% in 2018 to a peak of 175.36% in 2024, indicating that the company's ability to cover short-term obligations was positive but uneven. These changes were driven by variations in current assets, particularly trade receivables and inventory buildup linked to contract schedules, against rising short-term liabilities such as trade payables and bank loans. Liquidity dipped in 2018 due to increased liabilities and constrained asset growth, whereas a similar decline in 2021 was caused by reduced assets from vendor payments amid shrinking sales. Conversely, years such as 2019, 2020, and 2024 saw improved liquidity due to strong inventory accumulation and capital infusions outpacing liability growth. The nature of current liabilities, primarily trade payables and unearned income from procurement contracts, explains some volatility, as these obligations depend on the timing of goods delivery and revenue recognition. Importantly, the company's liquidity remained above the critical 100% threshold throughout, suggesting an adequate short-term financial buffer. This pattern indicates that while the company maintains reasonable liquidity, it remains vulnerable to procurement delays and cyclical state spending, highlighting the need for improved working capital planning and more predictable budget execution.

The average value of liquidity in the defense industry in Bandung is 146.5638, or 146.56%, meaning that the relationship between the liquidity variable and the capital structure shows that if a company's liquidity increases, its capital structure decreases. This result is in accordance with the packing theory, where companies that have high liquidity can fulfill their short-term obligations [59]. In practice, liquidity is still below the industry average because a good industry standard is 200% [54]. This is because company funding is strongly influenced by the policy of procuring funds from the government.

The study shows that profitability (proxied by the net profit margin—NPM) in the Bandung defense industry is highly volatile, ranging from 0.21% to 5.19%, with an average of 3.35%—well below the 20% industry benchmark for high-margin industries [60]. This fluctuation correlates with Indonesia's defense procurement calendar and broader macroeconomic trends, including electoral cycles and foreign exchange pressures. For example, the decline in profitability in 2022 coincided with pre-election budget constraints and rising costs of imported materials.

The profit volatility demonstrates the high exposure of defense manufacturers to budgetary politics, which makes the case for more resilient internal cost structures. This suggests that internal profitability improvements—via lean production, enhanced project execution, and reduced inventory holding—are crucial to weathering state procurement uncertainties [61]. This contributes to both managerial accounting practices and public finance strategies, offering policymakers and corporate decision-makers alike a data-driven warning that profit margins are structurally constrained by overreliance on state clients [9].

3.1.3 Liquidity ratios reflect inventory and receivable strategies

Capital structure is a financial description of a company in financing its assets from both long-term and short-term debt, which is a measure of the level of trust for investors. Capital structure (Y) in this study is proxied by the debt-to-equity ratio. The debt-to-equity ratio is a ratio used to assess the debt and equity of a company, to determine the extent to which the owner of the capital can cover the debt it has to outsiders; from the results of the study, a description of liquidity proxied by the debt-to-equity ratio at the defense industry in Bandung in 2017--2024 is as follows:

Table 3: Capital structure of the defense industry in the Bandung period from 2017--2024

Years	Total Debt	Total Equity	Capital Structure (%)
2017	986.758.431.123	251.975.069.176	391,6
2018	1.114.560.293.308	298.136.215.911	373,84
2019	1.845.083.798.751	674.105.126.536	273,7
2020	2.146.411.642.532	616.614.331.370	348,09
2021	2.044.080.858.094	579.560.996.111	352,69
2022	2.563.971.793.263	1.273.217.008.816	201,37
2023	2.619.592.394.008	1.259.052.402.693	208,06
2024	4.365.912.674.273	1.272.894.005.884	342,99

Source: Financial and recurring data of the defense industry in Bandung

On the basis of Table 3, the capital structure of the defense industry in Bandung—measured by the debt-to-equity ratio (DER)—exhibits significant annual fluctuations from 2017--2024, reflecting a dynamic interplay between financing strategies, procurement cycles, and state interventions. The DER peaked at 391.6 in 2017 because of high trade payables and bank loans. While occasional equity increases (notably from State Capital Investment/PMN) partially stabilized the ratio in subsequent years, such as in 2019 (DER 273.7) and 2022 (DER 201.4), structural volatility persisted. The most dramatic rebound occurred in 2024, when rising liabilities drove DER back to 343.0, despite marginal equity growth. This trajectory reveals a financial strategy heavily reliant on debt, with equity infusions serving as temporary stabilizers rather than systemic correctives. The company's capital policy targets a maximum DER of 3:1 (or 300%) to balance risk and return, yet actual figures often exceed this benchmark, signaling potential overleverage. The average DER of 311.54% during the observed period suggests that the firm's capacity to absorb debt remains suboptimal, failing to meet internal standards. This imbalance is compounded by the firm's dependency on a narrow client base—namely, the TNI, Ministry of Defense, and POLRI—which accounts for approximately 80% of total sales, limiting revenue diversification and delaying receivable turnover. These findings highlight the need for more resilient and diversified capital management strategies to enhance a company's financial sustainability amid procurement-driven volatility.

Liquidity, as measured by the current ratio (CR), generally remains above 120%, peaking at 175.36% in 2024, with an average of 146.56%. These levels suggest a cautious but not excessive short-term buffer, which is consistent with capital-intensive industries with long production cycles. The primary contributors to liquidity were inventory build-ups**,** state capital injections (PMNs), and accounts receivable tied to long-term contracts. Notably, 2021 witnessed a temporary liquidity dip driven by inventory surpluses amid contract delays—a warning about the mismatch between operational commitments and the reality of procurement.

The negative regression coefficient ($\beta = -0.094$) between liquidity and capital structure implies a trade-off behavior consistent with pecking order theory [62]When internal liquidity is strong, the company prefers internal financing and reduces reliance on debt (see Table 4). However, the relationship was not statistically significant ($p = 0.960$), implying that liquidity is managed tactically rather than strategically to influence the financing structure. This weak statistical relationship, while counterintuitive, reveals that institutional mandates may outweigh pure financial optimization in government-linked entities—a critical insight for public sector financial governance.

3.2 Multiple regression analysis: weak predictive power

Multiple regression analysis is used to predict the change in the dependent variable value, which is the capital structure, if the independent variable value, which is profitability and liquidity, increases or decreases in value. In this study, multiple regression analysis is used because the variables being studied consist of two independent variables, namely, profitability X1 and liquidity X2, and one dependent variable, namely, capital structure. The results of the calculation can be seen in Table 4.

Table 4: Results of multiple regression analyses

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
		B	Std. Error	Beta	T	Sig.	Tolerance	VIF
1	(Constant)	235,995	289,063		,816	,451		
	Profitability	26,655	17,760	,574	1,501	,194	,908	1,101
	Liquidity	-,094	1,803	-,020	-,052	,960	,908	1,101
a. Dependent Variable: Capital Structure								

Source: SPSS Processing Results version 20

Based on the results of multiple regression analysis from Table 4, the results of obtaining multiple regression equations are as follows:

$$Y = 235{,}995 + (26{,}655) + (-0{,}094) + e$$

The coefficients in the equation are meaningful:

a. From the multiple linear regression equation, the constant value is 235.995. The positive constant value assumes that without adding profitability and liquidity, the capital structure does not increase by 235.995.
b. The regression coefficient of profitability (X1) is positive for capital structure, indicating a positive relationship between profitability (X1) and capital structure (Y). The regression coefficient of the X1 variable is 26.655, which implies that every increase in profitability by one unit is predicted to increase capital structure by 26.655. Profitability has a positive but insignificant effect on capital structure (β = 26.655, p = 0.194).
c. The liquidity regression coefficient is negative toward capital structure, which shows the opposite relationship direction between liquidity and capital structure (Y). The regression coefficient of the X2 variable is -0.094, which implies that every addition of liquidity by one unit is predicted to cause a decrease in capital structure of -0.094. Liquidity has a negative and insignificant effect (β = –0.094, p = 0.960).
d. The combined model explains only 33.6% of capital structure variance (R^2 = 0.336).

These outcomes indicate that while there are theoretically plausible relationships, other unexamined variables (e.g., procurement timing, inflation, political intervention) likely account for the majority (66.4%) of capital structure variation. This affirms the complexity of applying conventional financial models to public-sector industrial entities, where decision-making is constrained by policy, not market rationality [63], [64].

From the perspective of institutional theory [12]The weak predictive power of profitability and liquidity reflects how state-owned defense enterprises are shaped less by internal efficiency logics than by institutional isomorphism. Coercive pressures from government procurement rules, mimetic tendencies to follow other SOEs' financing structures, and normative expectations from regulators and political stakeholders collectively distort financial decision-making. In this context, capital structure becomes a product of institutional conformity rather than rational optimization. Thus, the statistically insignificant influence of profitability and liquidity underscores that these firms' financing patterns are embedded in broader state-driven institutional frameworks, limiting the explanatory capacity of classical financial ratios.

3.2.1 Correlation coefficient

The correlation coefficient is used to measure the strength of the relationship between the independent variable and the dependent variable.

Table 5: Correlation coefficient output results

Correlations				
		Profitability	Liquidity	Capital Structure
Profitability	Pearson Correlation	1	-,303	,580
	Sig. (2-tailed)		,466	,132
	N	8	8	8
Liquidity	Pearson Correlation	-,303	1	-,194
	Sig. (2-tailed)	,466		,646
	N	8	8	8
Capital Structure	Pearson Correlation	,580	-,194	1
	Sig. (2-tailed)	,132	,646	
	N	8	8	8

Source: SPSS Processing Results version 20

Table 5 shows the calculation of the Pearson correlation between all the variables. The correlation value between profitability (X1) and capital structure (Y) is 0.580 or 58%, indicating a moderate positive relationship. This means that as profitability (measured by NPM / net profit margin) increases, capital structure also increases. However, the relationship is insignificant, as the significance value (sig) is 0.132, which is greater than 0.05. The correlation value between liquidity (X2) and capital structure (Y) is -0.194 or 19.4%, indicating a very weak negative relationship. This means that as liquidity (measured by CR / current ratio) increases, capital structure decreases. This relationship is also insignificant, as the significance value (sig) is 0.646, which is greater than 0.05.

3.2.2 Coefficient of determination (correlation matrix: directional but inconclusive)

The coefficient of determination is obtained based on the results of the correlation between variables; from calculations via SPSS 20, the amount of influence simultaneously on the results of the coefficient of determination can be seen in Table 6 as follows:

Table 6: Output Results of the Coefficient of Determination

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,580[a]	,336	,071	71,55946
a. Predictors: (Constant), Liquidity, Profitability				
b. Dependent Variable: capital structure				

Source: SPSS Processing Results version 20

Table 6 shows an R-squared of 0.336, which means that profitability (NPM) and liquidity together affect the capital structure by 0.336 or 33.6%, respectively. The conclusion is that 33.6% profitability (NPM) and liquidity affect the capital structure in the defense industry in Bandung for the period 2017-2024, and the remaining 66.4% is influenced by other variables outside the study area.

The Pearson correlation between profitability and capital structure was moderately positive (r = 0.580), suggesting that as profit improves, so does the company's ability to take on more debt—a behavior observed in growth-phase industrial firms. However, liquidity's correlation was very weak and negative (r = –0.194), underscoring its role more as a buffer than a driver. This pattern aligns with studies on government manufacturing sectors, where liquidity cushions are built more to navigate bureaucratic delays than to signal creditworthiness [65].

3.2.3 Hypothesis testing and model limitations

Furthermore, to prove whether profitability and liquidity significantly influence capital structure (proxied by DER) partially or simultaneously, hypothesis testing is conducted. Partial hypothesis testing was performed, and simultaneous testing was continued. The hypothesis to be tested in this study is the extent of the influence of independent variables, namely, profitability and liquidity.

3.2.3 Partial hypothesis testing (t-test): no significant effects

Partial testing is used to determine more clearly which of the two independent variables, namely, profitability and liquidity, has a significant effect on capital structure. To determine the influence and significance level partially, a t-test or Sig table is used as follows:
This section analyzes the effect of profitability on capital structure via a partial t-test to evaluate the formulated hypothesis. The null hypothesis (H0) posits that there is no significant relationship between profitability and capital structure ($\beta = 0$), whereas the alternative hypothesis (Ha) suggests that a significant influence exists ($\beta \neq 0$). Decision-making in the t-test adheres to the following criteria: H0 is accepted (and Ha rejected) if the calculated t value (tcount) is less than the critical value from the t distribution table (ttable) or if the significance level (Sig.) exceeds 0.05. Conversely, H0 is rejected (and Ha accepted) if tcount exceeds ttable or if Sig. < 0.05.

Table 7: Partial Test (t-test) Profitability

Coefficients[a]					
Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	235,995	289,063		,816
	Profitability	26,655	17,760	,574	1,501
	Liquidity	-,094	1,803	-,020	-,052
a. Dependent Variable: capital structure					

Source: SPSS Processing Results version 20

With a significance level set at 5% (two-tailed) and degrees of freedom (df) of 5 (n = 8, k = 3), the critical t-table value is 2.570. SPSS 20 output yields a t-count for profitability of 1.501 (see Table 7), with a significance value of 0.194. This result clearly shows that tcount < ttable (1.501 < 2.570) and Sig. > 0.05, leading to the acceptance of H_0. Therefore, profitability does not have a statistically significant partial effect on a company's capital structure within the scope of this dataset. Despite a positive beta coefficient of 26.655 indicating a positive direction, the lack of statistical significance implies that variations in profitability do not reliably explain changes in capital structure in this sample. This finding suggests that other factors may have stronger explanatory power with respect to capital structure decisions.
We begin by stating our hypothesis clearly. The null hypothesis (H_0) posits that liquidity has no significant effect on capital structure ($\beta = 0$). Conversely, the alternative hypothesis (H_a) asserts that liquidity does have a significant effect on capital structure ($\beta \neq 0$). This framework establishes our objective: to determine whether liquidity plays a meaningful role in shaping a firm's financing decisions.
To evaluate our hypothesis, we employ a two-tailed t-test with a 5% significance level ($\alpha = 0.05$). Our decision rule is straightforward: (1) If tcount < ttable or if the p value ("Sig.") exceeds 0.05, we fail to reject H_0—concluding that liquidity does not significantly influence capital structure. (2) If tcount > table or if the p value is less than 0.05, we reject H_0 in favor of H_a—indicating a significant relationship between liquidity and capital structure.
With a sample size of n = 8 and three variables (k = 3), our degrees of freedom (df) are calculated as n–k = 5. Consulting a t-distribution table for df = 5 and a two-tailed $\alpha = 0.05$, we obtain the critical value: $t_{table} = \pm 2.570$.

Table 8: Partial Test (t-test) Liquidity

Coefficients[a]					
Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	235,995	289,063		,816
	Profitability	26,655	17,760	,574	1,501
	Liquidity	-,094	1,803	-,020	-,052
a. Dependent Variable: capital structure					

Source: SPSS Processing Results version 20

Based on the SPSS output for the regression coefficient related to liquidity (B = –0.094, Std. Error = 1.803), the t statistic tcount is computed as –0.052. This small negative t value indicates that the estimated coefficient is very close to zero relative to its standard error.
When we compare the observed t value with our critical threshold, we see that –0.052 is well within the acceptance region –0.052 < 2.570. Additionally, the p-value associated with the liquidity coefficient is 0.960, which far exceeds our alpha level of 0.05. Both criteria—an insignificant t value and a high p value—lead us to fail to reject the null hypothesis. In clearer terms, this analysis demonstrates that liquidity does not have a statistically significant effect on capital structure in this sample, lending support to H_0.
These t-tests confirm that neither profitability nor liquidity individually explains capital structure dynamics, emphasizing the need for multifactor financial models that include state-driven variables such as political cycles, regulatory delays, and public procurement processes [43].

3.2.4 Simultaneous hypothesis testing (F Test): no joint significance

After the R^2 value is known, it is tested to determine whether the determination value has a significant effect. This F test is used simultaneously to test how much influence the independent variable has on the dependent variable. Furthermore, to determine whether profitability and liquidity have a significant effect on the capital structure of the defense industry in Bandung from 2017--2024, it is necessary to test the hypothesis simultaneously, and the steps are as follows:
In examining the combined influence of profitability and liquidity on capital structure, we establish the following hypothesis: H_0: $\beta = 0$, indicating no significant joint effect, against H_a: $\beta \neq 0$, suggesting a meaningful combined impact. To evaluate this, we employed the F-test at a 5% significance threshold ($\alpha = 0.05$). Specifically, with two predictors—profitability and liquidity—the degrees of freedom were calculated as $df_1 = k - 1 = 2$ and $df_2 = n - k = 5$. Referring to the F-distribution table, the critical value (Ftable) was found to be 5.79.

Table 9: Simultaneous Test (F Test)

ANOVA[a]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	12982,842	2	6491,421	1,268	,359[b]
	Residual	25603,784	5	5120,757		
	Total	38586,626	7			

a. Dependent Variable: capital structure
b. Predictors: (Constant), Liquidity, Profitability

Source: SPSS Processing Results version 20

Using SPSS 20, the analysis yielded an F-statistic (F_{ont}) of 1.268 (see Table 15), accompanied by a significance level (p-value) of 0.359. Since F_{count} (1.268) falls well short of F_{table} (5.79) and the p-value (0.359) exceeds our 0.05 threshold, we cannot reject the null hypothesis. The F test results indicate that profitability and liquidity do not jointly influence capital structure significantly. This finding reinforces the notion that financial management in the Bandung defense industry is largely exogenous and is governed by state budget flows and strategic directives rather than operational performance metrics. In other words, there is insufficient evidence to assert that profitability and liquidity, when considered together, exert a statistically significant effect on capital structure.

3.3 Research outcomes with enduring value

The capital structure (proxied by the debt-to-equity ratio—DER) exhibits severe volatility, ranging from 201.4% to 391.6%, with an average of 311.54%—above the internal benchmark of 300%. These high DER levels are largely attributable to backlog-based financing models, delayed receivables, and reliance on short- and long-term bank loans for capital expenditures and operating costs. Equity injections through the PMN serve to rebalance the structure periodically, but the general trend shows a heavy dependency on external debt, which potentially increases the financial risk exposure of the firm in times of procurement slowdown or interest rate hikes.

The fluctuating capital structure underscores the fragility of the firm's balance sheet and calls for restructuring strategies such as equity mobilization from commercial markets, state guarantees, or blended finance. Theoretically, this finding supports the trade-off theory [66], which posits that firms balance the tax shield of debt against bankruptcy costs. Here, however, the balance appears to be reactive and not optimized. The research thus contributes to the literature by illustrating how state-owned enterprises (SOEs) or GLCs may be less responsive to classical capital structure theories due to political–economic constraints [67], [68].

Beyond trade-off and pecking order logics, the behavior of Bandung's defense firms can also be explained through the lens of institutional theory [12]. Their concept of institutional isomorphism suggests that organizations—particularly SOEs—adopt structures and financial practices not solely for efficiency, but to conform to regulatory mandates, political expectations, and legitimacy pressures. In this case, high leverage and recurring state equity injections are less the result of strategic optimization than of coercive pressures from procurement laws, budget cycles, and state-led industrial policy. This conformity to state norms explains why capital structure adjustments are often reactive and ritualized, prioritizing alignment with government oversight rather than market-based efficiency.

This study adds empirical weight to the argument that classic capital structure theories (e.g., pecking order, trade-off) are contextually limited in state-owned or defense-oriented industries. It invites the need for hybrid models incorporating state policy variables (procurement law, budget cycles), geopolitical uncertainty (election years, import restrictions), and institutional inertia in project financing (delays, disbursement lag). These insights are consistent with the literature on institutional theory in finance [12], which argues that organizational outcomes in public institutions are shaped more by legitimacy and conformity to state norms than by pure efficiency.

This study presents a rare empirical window into the financial management of Indonesia's defense manufacturing sector, shedding light on how profitability, liquidity, and capital structure interact in a context dominated by state procurement, political budgets, and exogenous shocks. Key outcomes include the following: (1) Demonstrating the moderate but statistically insignificant relationship between profitability and capital structure. (2) Identifying a nonlinear, context-specific linkage between liquidity and financing strategy. (3) Two classical financial indicators (profitability and liquidity) explain only a third of capital structure variance—underscoring the importance of including institutional, regulatory, and political variables in future models.

4. Discussion

4.1 Profiling profitability, liquidity, and capital structure: sectoral distinctiveness and structural challenges

This study provides a financial diagnosis of Bandung's defense industry from 2017-2024, revealing insights that are underrepresented in the corporate finance literature. Key financial indicators—profitability, liquidity, and capital structure—significantly deviate from industry benchmarks. Profitability, measured by the net profit margin (NPM), remained below the 20% standard. This underperformance results from a monopsonistic market, where nearly 80% of production is absorbed by institutional clients such as the Ministry of Defense, Indonesian National Armed Forces (TNI), and the National Police (POLRI), which operate under rigid procurement and pricing schemes.

Liquidity, as measured by the current ratio, also underperformed relative to the industry norm (200%). This is due mainly to trade payables and short-term obligations, despite periodic state capital participation (PMN). These liquidity constraints are systemic, arising from timing mismatches between fund disbursement, procurement cycles, and contract execution.

Importantly, these deviations are not purely financial outcomes but are tightly linked to the rhythm of political budgets. Defense firms' revenues depend on state budget allocations, which fluctuate with election cycles, parliamentary debates, and annual government appropriations. In practice, profitability contracts during pre-election years, when defense spending is often redirected to populist programs, while liquidity rises artificially after large disbursements of capital injections at the start of fiscal years. These politically determined flows distort financial ratios by inflating or suppressing key metrics independently of operational efficiency. For instance, sharp declines in profitability in 2022 coincided with budgetary reallocations ahead of national elections, underscoring how political budgets—not firm strategy—dictate financial performance.

From the perspective of institutional theory [12]These deviations illustrate how state-owned defense firms conform less to efficiency-driven logics and more to coercive, mimetic, and normative pressures. Coercive pressures emerge from government procurement rules, fiscal oversight, and regulatory mandates that dictate how capital is allocated rather than allowing firms to optimize it internally. Mimetic pressures are evident in the reliance on debt-heavy financing, which mirrors practices of other SOEs facing similar budgetary constraints and political demands [69]. Normative pressures arise from professionalized bureaucratic routines that prioritize compliance with state

regulations over financial efficiency. Together, these institutional forces explain why capital structure decisions are shaped less by profitability or liquidity metrics and more by state-driven imperatives. This framing highlights that Bandung's defense industry is embedded in an organizational field where financial behaviors reflect conformity to state norms, not market rationality.

Furthermore, the capital structure—measured by the debt-to-equity ratio (DER)—has consistently fallen short of strategic targets, indicating an imbalance in funding sources. Ideally, firms in capital-intensive sectors such as defense manufacturing would leverage long-term financing to smooth asset cycles and ensure sustainability. However, in practice, these firms often rely on short-term debt to fulfill long-gestation projects, exposing them to rollover risks and interest rate vulnerabilities. This mismatch underscores the need to re-examine capital structure theories—such as the trade-off theory [70] and the pecking order theory [62]—in the context of state-dependent industries where market forces and procurement regulations play a decisive role.

4.2 Profitability's influence on capital structure: A sector-centered reassessment

The regression results reveal that profitability, proxied by net profit margin (NPM), has a positive but statistically insignificant effect on capital structure ($\beta = 0.574$, $p = 0.194$). This finding indicates that while higher profits tend to co-occur with higher leverage levels, the relationship is not robust enough to reject the null hypothesis at conventional significance levels. This finding is crucial, as it diverges from mainstream financial theory and empirical studies, which suggest that more profitable firms prefer lower leverage because of their ability to finance operations internally [71], [72].

The statistical insignificance of profitability's effect must be interpreted through the prism of market constraints. Defense firms in Bandung operate under exogenously determined demand conditions. As most revenue is secured through public contracts, profit margins are less elastic and less reflective of internal efficiency. Instead, regulatory frameworks—such as Law No. 16/2012—play a pivotal role in shaping revenue streams. While this law introduced stricter quality and security standards, it also catalyzed industrial growth by securing stable demand pipelines.

The surge in profits observed post-2019 coincided with increased government spending on military modernization, facilitating capacity expansion and workforce upskilling. However, this was not sustained. The period from 2021–2022 saw a sharp decline in net profit, driven by global macroeconomic pressures, notably the rupiah's depreciation of over 12% and rising import costs. Equally important, these declines were amplified by political budget reallocations in the run-up to national elections, when fiscal resources were diverted toward populist programs rather than defense procurement. As a result, profitability was shaped not only by operational or macroeconomic conditions but also by the volatility of political priorities. This suppressed profit margins and diluted the ability of firms to reduce leverage through retained earnings.

Such externalities reduce the predictive power of NPM for capital structure, suggesting that in quasipublic industries, profitability is a necessary but insufficient determinant of capital policy. The defense sector thus exemplifies how profitability, though measurable, is highly contingent on state budgeting decisions rather than endogenous financial performance.

This study's findings diverge from past works, such as those of Hadiah & Suwitho [53] and Achmad & Triyonowati [39], who reported significant positive effects of return on equity (ROE) on capital structure in nondefense industries. Moreover, Nastiti & Andayani [37] identified a negative relationship between return on assets (ROA) and DER. These inconsistencies suggest industry-specific financial behaviors, indicating that defense manufacturing—particularly under public procurement—requires a tailored analytical framework. Profitability (NPM) consistently remained below the 20% industry benchmark [54], highlighting the influence of public-sector contracts. The results are specific to Bandung's defense sector and should be cautiously applied elsewhere with similar variable structures.

4.3 Liquidity and capital structure: The myth of flexibility

The effect of liquidity on capital structure was even more negligible than that on profitability, with a standardized beta coefficient of –0.020 and a p-value of 0.960. Despite the theoretical premise that liquidity improves firms' ability to avoid excessive borrowing [73]This study suggests otherwise in the case of Bandung's defense industry. The current ratio exhibited fluctuations throughout the period but failed to significantly influence capital structure decisions.

This can be traced to two structural realities. First, liquidity levels were artificially elevated because of irregular capital injections from the state (PMN). For example, in 2019 and 2022, the firm received IDR 300 billion and IDR 700 billion, respectively, which inflated current assets without a corresponding increase in operational liquidity. These funds were earmarked for fixed asset procurement and could not be reallocated to short-term liabilities, limiting their influence on capital structure optimization.

Second, the accumulation of current liabilities, such as trade payables and unearned revenues, counterbalanced asset growth. These liabilities were closely linked to procurement lead times and milestone-based payments. As such, the reported liquidity ratios often misrepresent the actual cash availability for debt servicing or equity strengthening. In other words, high liquidity ratios in this context do not imply high financial flexibility.

Historical debt legacies further complicate the picture. Government loans from the 1980s, undertaken to modernize manufacturing infrastructure, remain on the books. Although there were plans to convert this into equity, administrative bottlenecks delayed the process, thereby increasing reported liabilities. Such inherited burdens distort the relationship between liquidity and leverage, further eroding the explanatory power of liquidity metrics.

In this context, a firm's capital structure appears to be decoupled from liquidity management. Strategic decisions are more likely to be influenced by political and institutional mandates than by internal financial indicators. Thus, while liquidity is a critical metric in standard corporate finance, it has limited utility in explaining capital behavior in publicly anchored defense enterprises.

Finally, it is worth noting the broader strategic and industry context. The company's earlier path—part of the Progressive Manufacturing Plan—diversified into unrelated conglomerates that did not yield anticipated growth. It was only post-1998 that the firm pivoted toward defense-related equipment, concentrating its focus by 2019 before branching out to adjacent industrial products. Moreover, its liquidity metric has consistently fallen short of industry benchmarks: the current ratio hovered below the recommended 200% [54], underscoring its reliance on institutional clients such as the TNI, Ministry of Defense, and Police. Given these unique strategic and historical conditions, the study's conclusions—that liquidity has negligible influence on capital structure—hold primarily for Bandung's defense industry and may not be generalizable to firms in different sectors or regions.

4.4 Joint impact of profitability and liquidity: partial insight, broader questions

Profitability (measured by the Net Profit Margin) and liquidity (measured by the Current Ratio) together explain 33.6% of the variation in capital structure (measured by the Debt-to-Equity Ratio). In other words, these two financial ratios account for roughly one-third of what drives companies' capital leverage. The remaining 66.4% of the variation stems from other factors not captured in this study. This finding signals that while profitability and liquidity matter, there is a substantial influence from additional variables—such as firm size, growth opportunities, asset structure, or macroeconomic conditions—that require further exploration.

When subjected to joint hypothesis testing (the F- test), the study revealed an F statistic of 1.268, which is lower than the critical F value of 5.79 at the conventional significance level. Additionally, the p-value associated with this testing was 0.359—well above the 0.05 threshold—leading to acceptance of the null hypothesis. In practical terms, this result means that despite the 33.6% explanatory power, profitability and liquidity together do not exert a statistically significant effect on capital structure within the sample. This suggests that any observed relationship may be due to chance rather than a consistent, underlying economic linkage.

A closer reading reveals that much of the unexplained variance can be attributed to political budget cycles**.** For instance, capital injections through PMN (State Capital Participation) in 2019 and 2022 temporarily reduced leverage, but these were not driven by internal profitability or liquidity considerations. Instead, they reflected fiscal policy decisions tied to broader political agendas. Conversely, in 2021—a year marked by tighter fiscal constraints and delayed disbursements—capital structure deteriorated sharply, showing how political budget volatility overshadowed internal financial metrics.

In the specific context of the Bandung-based defense industry from 2017–2024, DER demonstrated notable volatility and consistently fell short of industry norms. Management in this sector worked actively to optimize its capital structure, adhering to a self-imposed ceiling of a 3:1 debt-to-equity ratio to maintain business stability and preserve company value. Notable events included major equity injections in 2019 and 2022 via state capital participation (PMN), which temporarily bolstered equity and reduced leverage. Conversely, 2021 was a difficult year: a sluggish global economic recovery, a 12% depreciation of the rupiah (to IDR 11,812/$), and overarching economic headwinds led to diminished equity, underscoring the sector's susceptibility to macroeconomic stress.

Taken together, the evidence suggests that Bandung's defense industry operates less as a profit-maximizing enterprise and more as a fiscal instrument of state policy. Political budgetary decisions—when and how much to disburse, reallocate, or delay funding—emerge as stronger determinants of capital structure than internal measures of profitability and liquidity.

This invites a broader exploration of additional factors that may shape capital structure, including firm size, age, asset tangibility, interest rate conditions, and policy volatility. For example, firms with larger asset bases may find it easier to secure long-term loans in favorable terms, which affects leverage ratios. Similarly, government contract timelines and payment cycles may create cyclical fluctuations in financing needs.

Importantly, this study refines the existing body of literature, such as the work by [39], [74], [75]—by incorporating net profit margin (NPM) as a direct measure of profitability and ranking the explanatory strength of independent variables. The empirical model used in this study highlights the greater influence of profitability (NPM coefficient = 0.580) than liquidity (CR / current ratio coefficient = –0.022), aligning with theoretical propositions that firms with stable profit margins are better positioned to manage their leverage [22]. However, the insignificance of both in joint modeling reiterates the context dependency of these relationships. While conventional wisdom assumes a linear, predictable relationship between internal financial metrics and capital policy, this study demonstrates that in regulated, contract-driven sectors, such relationships may be disrupted by exogenous factors. This clarity in comparative influence addresses gaps in prior research, offering more precise guidance: companies with healthier profit margins may find it easier to approach or maintain the optimal DER threshold—and potentially, that profitability plays a more decisive role than liquidity in this particular sector.

4.5 Theoretical and practical implications: toward contextualized financial strategy

From a theoretical standpoint, the findings challenge the universality of capital structure theories. The Trade-Off Theory assumes that firms balance tax shields from debt with financial distress costs, whereas the Pecking Order Theory posits a financing hierarchy on the basis of information asymmetry. Neither fully accommodates the structural rigidity of defense firms, whose revenue flows, pricing mechanisms, and financing decisions are mediated by government policy rather than market signals.

Institutional theory [12] provides a complementary lens to interpret these dynamics. Defense firms in Bandung operate within a highly institutionalized field where coercive pressures (state regulations, budget allocations, and procurement rules), mimetic pressures (adoption of similar financing practices across SOEs), and normative pressures (bureaucratic routines and expectations of compliance) strongly shape financial strategies. These institutional forces explain why profitability and liquidity—while relevant indicators—have limited explanatory power: capital structure decisions are embedded in a broader logic of legitimacy and conformity to state mandates rather than efficiency. Thus, institutional isomorphism helps clarify why Bandung's defense firms continue to rely on debt-heavy financing structures even when such practices deviate from conventional financial rationality.

Practically, this study provides a framework for financial managers and policymakers in state-linked industries to rethink the application of financial ratios. Profitability must be interpreted alongside contract structure, funding cycles, and policy shifts. Liquidity, particularly when inflated by capital injections, should not be equated with leverage control unless it is tied to flexible asset reallocation. In addition, firms should diversify beyond government contracts to reduce overreliance on state procurement cycles. Developing a more balanced portfolio—including commercial clients and international partnerships—can stabilize revenue flows. Furthermore, hybrid financing mechanisms such as defense bonds, sovereign-backed investment vehicles, or blended finance schemes could provide alternative capital sources that are less volatile and more sustainable than traditional debt.

The consistent shortfall in DER relative to industry standards indicates that capital structure optimization remains an aspirational goal. The firm's self-imposed 3:1 DER ceiling reflects a cautious approach to financial stability, particularly in light of past debt mismanagement and the need to safeguard national strategic assets. PMN injections, although helpful in the short term, must be complemented with sustainable revenue models and diversified financing instruments—such as defense bonds or sovereign-backed investment vehicles.

This study contributes novel empirical insight into Bandung's defense industry—a sector rarely examined in the capital structure literature. It establishes that profitability has a stronger (albeit statistically insignificant) effect on leverage than does liquidity and that both jointly explain a modest share of capital structure variation. The findings underscore the sector's unique financial behavior, shaped more by institutional structures and policy environments than by internal operational metrics.

However, limitations remain. The model does not account for macroeconomic variables such as interest rate volatility, inflation, or foreign exchange movements. Future research could integrate these factors via advanced econometric techniques such as panel VAR or GMM to capture causality and lag effects. In sum, the financial behavior of defense manufacturing firms—particularly in developing economies

with strong state involvement—demands context-sensitive models. The findings encourage scholars and practitioners to transcend textbook theories and build frameworks rooted in institutional realities.

5. Conclusion

This study examines the underperformance of Bandung's defense industry by analyzing the relationships among financial indicators—profitability (NPM), liquidity / current ratio (CR), and capital structure (DER). The findings indicate that profitability and liquidity do not significantly influence capital structure, either individually or jointly. There is a moderate positive correlation between NPM and DER and a weak negative correlation between CR and DER, but these relationships lack statistical significance. This suggests that, unlike conventional financial theory, which asserts that internal financial health guides capital structure decisions, Bandung's state-owned defense enterprises are influenced more by exogenous or strategic nonfinancial factors—such as state policy, defense contracts, and geopolitical priorities.

This divergence highlights the need to rethink capital structure theory in the context of state-linked strategic sectors. This study challenges the applicability of pecking order or trade-off theories in situations where financial strategy is secondary to national security goals. Practically, the findings are useful for policymakers and corporate strategists. Interventions to improve operational efficiency—through cost control, reduced import dependency, and asset productivity—are essential, even if their direct impact on capital structure is limited. Enhancing internal financing via retained earnings and investments in capital-intensive technologies (e.g., automated defense production systems) can increase long-term fiscal resilience. From a practical and policy standpoint, the findings call for diversification beyond exclusive reliance on government contracts and the exploration of hybrid financing instruments such as defense bonds or sovereign-backed securities. Such mechanisms can help reduce dependency on state budget cycles, broaden the investor base, and provide more resilient long-term funding alternatives.

While the insights from this study offer valuable contributions, the findings are specific to the Indonesian defense sector and should be interpreted with caution when generalized to other industries or national contexts. Defense manufacturing operates under unique institutional, regulatory, and political constraints that may not apply elsewhere. Thus, broader application of the results—particularly to private-sector or non-strategic industries—requires careful contextual adaptation.

Future research should investigate broader institutional and macroeconomic variables—such as state ownership structure, political patronage, and regulatory constraints—to develop a more contextualized capital structure model for defense and strategic industries. Moreover, future studies could employ advanced econometric approaches, including panel vector autoregression (VAR) models, to capture the dynamic interactions between profitability, liquidity, leverage, and external shocks such as inflation, interest rates, or exchange rate fluctuations. This methodological expansion would not only address omitted variable concerns but also allow for testing causal mechanisms across time and policy cycles. By integrating financial and nonfinancial dimensions, this study establishes a framework that aligns financial strategy with organizational goals and national priorities.

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